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ECONOMIC OUTLOOK

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OIL PRICES, THE DOLLAR AND THE U.S. OUTLOOK

by

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The convergence of two events, the continued decline in the value of the U.S. dollar and the collapse of oil prices, has significantly improved the outlook for the U.S. economy. To be sure, both of these occurrences have advantages and disadvantages. For instance, while the dollar's strength during much of this decade wreaked havoc with our exporting industries, it also contributed to the deceleration in the rate of growth in consumer prices. Similarly, while the inflationary shocks resulting from the 1973 and 1979 increases in oil prices dampened economic activity worldwide, it was certainly a boon for the domestic oil and related industries and regions. Despite the pluses and minuses associated with these two events, we believe, as this article explains, that they will be a net plus for the United States economy.

Lower Oil Prices: Domestic Impact

During the 1970s, the U.S. economy was characterized by spiraling rates of inflation, caused, in part, by the 1973 and 1979 oil price shocks, and increases in other commodity prices. Although the dramatic reduction in inflation during the 1980s reflects several developments, including monetary restraint, the slide in petroleum prices, from a peak of $35 per barrel in early 1982 to an average of $28 per barrel in 1985, contributed to some measure of price stability.

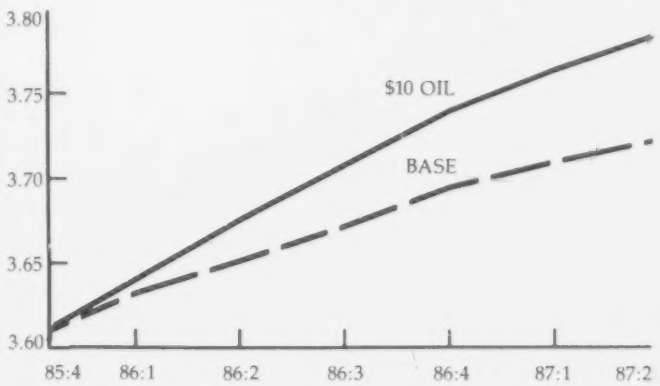
After studying the issue extensively (see ECONOMIC OUTLOOK, March 1983 and May 1984 issues), we have concluded that despite the negative impact on the domestic oil industry and the regions which are dependent on the energy sector, the decline in petroleum prices is a welcome shot in the arm for the American economy as a whole.

Table 1 shows the results of our econometric analysis of the impact on the U.S. economy of a $10 per barrel drop in the price of oil. A sustained $10 drop raises the *level* of real gross national product (GNP) by 0.8 percent in the first year and 1.6 percent in the second year compared to what would otherwise have been the case (see Chart 1). In terms of *growth rates*, this means that the oil price decline adds 1.2 percentage points to real GNP growth in 1986 and 1.0 percentage point in 1987.

CHART 1

IMPACT OF A $10 PER BARREL DROP IN OIL PRICES ON REAL GNP

(trillions 1982$)



IN THIS ISSUE

Oil Prices, the Dollar, and the U.S. Outlook ..... p. 1

Forecast Table ..... p. 8

It's Time to Restore Presidential Budgetary Power ..... p. 9

Pressure for Change in Financial Markets ..... p. 11

Trends in Commerce ..... p. 15

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TABLE 1

ECONOMIC IMPACT OF A $10 PER BARREL DROP IN THE PRICE OF IMPORTED OIL
(percentage difference from base unless otherwise indicated)

	1986	1987
GNP	0.5	0.8
Real GNP	0.8	1.6
Consumption	0.8	1.4
Nonresidential Investment	1.3	3.0
Residential Investment	2.1	4.1
Civilian Employment	0.4	0.9
Consumer Prices (1)	-1.1	-0.3
Implicit GNP Deflator (1)	-0.4	-0.4
3-Month Treasury-Bill Rate (2)	-30.0	-20.0
Corporate Bond Rate (2)	-10.0	-20.0

Note: The base simulation is the January Laurence H. Meyer and Associates (LHM&A) forecast (BASE601). The price of OPEC oil is $20 per barrel in both 1986 and 1987. The alternative simulation assumes that OPEC oil averages $10 per barrel in both 1986 and 1987.

(1) Percentage point difference.

(2) Basis point difference.

Source: U.S. Chamber of Commerce, Forecasting Section, using the Washington University (LHM&A) model of the U.S. economy.

Furthermore, our analysis shows that the rate of growth of the consumer price index will decline by 1.1 percentage points in 1986 and 0.3 percentage points in 1987. Lower inflation, and reduced expectations of future inflation, will contribute to lower interest rates. Indeed, domestic as well as foreign interest rates have already declined significantly.

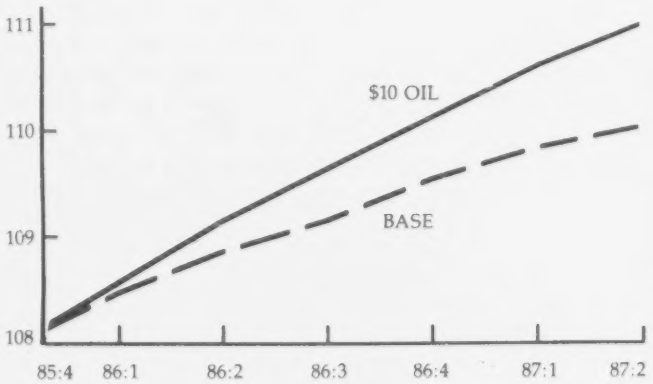
As interest rates fall, the outlook for credit-sensitive sectors, i.e., housing, automobiles and consumer durables, will strengthen considerably. This improvement will, in turn, bolster the outlook for those industries that supply these sectors, such as metals, textiles, electrical machinery, and stone, clay and glass. The drop in oil prices is a plus for energy-intensive industries, including the chemicals, plastics, steel and fertilizers industries, which bore the brunt of the price shocks of the 1970s. Furthermore, other industries, such as metals, cement and paper products, will benefit from the drop in residual fuels prices. The transportation sector, which accounts for 65 percent of U.S. oil demand, will be a major beneficiary, and all industries will eventually benefit from lower transportation costs.

The combination of lower energy costs and lower rates of interest will spur investment, both in the residential and nonresidential sectors. As a consequence, nonresidential investment should be 1.3 percent higher in 1986 and three percent higher in 1987 than would otherwise have been the case. Similarly, residential investment is anticipated to rise by 2.1 percent and 4.1 percent, respectively.

Higher levels of investment mean that more private sector jobs are created. As a result, civilian employment is 0.4 percent higher in 1986 and 0.9 percent higher in 1987 than would otherwise have been the case (see Chart 2).

CHART 2

IMPACT OF A $10 PER BARREL DROP IN OIL PRICES ON CIVILIAN EMPLOYMENT
(millions)



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Reduced business costs will find their way to consumers through a variety of channels. The most obvious improvement will be in the price of gasoline, heating oil, and electricity. In particular, consumer energy expenditures, which account for over seven percent of total consumer spending, will decline. Lower prices and higher employment raise real disposable income and consumer purchasing power. Consequently, consumer spending will be 0.8 percent higher in 1986 and 1.4 percent higher in 1987 than would have been the case without the oil price reduction. In particular, discretionary spending, on items such as household furnishings, automobiles and recreational and leisure activities, should improve. As a result, tourism-related industries can also be expected to benefit.

Not everyone will benefit, however. Texas, Oklahoma and Louisiana, whose local economies were cushioned from the past two recessions by their oil riches, are feeling the pain of adjustment to lower oil prices. However, the decline in oil prices did not come as a surprise. Last month's sharp drop was the fifth decline in three years. The domestic oil industry is simply continuing a process of adjustment which began then. Clearly, economic activity in these states and in oil-related industries will remain weak. Oil service industries, such as manufacturers of drilling equipment, are likely to be the hardest hit as the fortunes of the domestic oil industry decline. Despite this outcome, which is already manifesting itself, the drop in oil prices represents a net plus for the economy as a whole.

Lower Oil Prices: International Impact

Tumbling oil prices improve the economic outlook for the world economy as well. A $10 per barrel decline in the price of oil is estimated to raise real gross national product in the OECD (Organization for Economic Cooperation and Development) nations by about one percent. Similarly, it cuts average OECD inflation by between one percent to 1.5 percent, which allows interest rates to fall by about the same percentage. The resulting increase in world trade should benefit all nations, oil exporters and oil importers alike. For the United States, it means an increase in foreign demand for U.S. goods and services, thus buoying real export growth. Together with the decline in the value of the dollar, this will help narrow the trade gap.

Japan, which imports all of its crude petroleum and whose domestic energy requirements are dependent on petroleum-derived products, will be a major beneficiary of the oil price drop. By one estimate, the decline in oil prices spells the difference between a growing economy and the "mild growth recession" that had been forecast for that country. In spite of the fact that the oil price decline will reduce Great Britain's oil revenues, the net effect on its economy will be positive. This results from an increase in nonoil exports as the economies of its major trading partners strengthen. France, West Germany and Italy, all major oil importers, will enjoy substantially lower rates of domestic inflation and stronger growth. As is the case with Great Britain, Canada's energy sector will experience losses and cutbacks in investment. Nevertheless, nonoil exports will benefit. In particular, the improvement in U.S. economic activity represents an important boost to the Canadian economy since exports comprise 30 percent of Canadian GNP and the U.S. is its largest overseas market.

The biggest winners, however, will be the oil-importing nations: Brazil, South Korea, Taiwan, Greece, the Philippines, Chile and Uruguay. Not only will their oil import bill be reduced, but the increase in international trade, which will accompany a growing world economy, and decline in interest rates, which will result from lower inflation, mean that (1) their current account position will improve and (2) their debt service burden will decline. The indebted oil exporters—Venezuela, Nigeria, Mexico, Algeria, Indonesia, Malaysia, Ecuador and Egypt—will see a deterioration in their current account position as oil revenues drop, but they too will benefit from an increase in nonoil exports and a decline in their debt service burden.

While it is estimated that Mexico will lose about $3.6 billion in oil revenues from a $10 per barrel drop in the price of oil, it will gain about $1 billion from the reduction in its debt service burden which should result from falling interest rates. Estimates by American Express Bank show that with the price of oil at $20 per barrel, Brazil, the world's largest debtor country and an oil importer, saves $1.7 billion in oil charges and $1 billion in interest charges. World Bank estimates show that oil prices in the $17 to $18 per barrel range signify an $80 million saving on Chile's oil bill and a $60 million saving on Uruguay's oil bill. To this saving should be added the positive impact of increased exports and lower debt service burdens. It should be noted that both Mexico and Brazil have already been successful in securing lower interest terms in their latest meeting with their creditors.

Serious concern has been expressed regarding the impact of the oil price drop on the banks which have loans outstanding to the domestic oil industry and the indebted oil exporters. The fear is that the oil price decline might prompt a rash of defaults, including the likelihood that a major debtor country might default on its obligations. This raises the possibility that, in order to avoid bank collapses, the Fed will have to significantly increase the supply of money, thus risking a reacceleration of domestic inflation.

While the danger should not be taken lightly, this view fails to take account of several mitigating factors. In 1982, when the developing country debt became a serious problem, the world economy was in the midst of a serious recession and bank profits were weak. This time around, the U.S. economy is in its fourth year of a strong recovery and bank earnings have increased in tandem with the improvement in economic activity. Furthermore, the banks with the greatest exposure to the major debtor countries have used the past four years to strengthen their positions by raising their ratios of primary capital to assets and reducing the share of problem debts to total assets. As a result, they are in a significantly stronger position now than they were in 1982.

Although the oil price decline means that banks will probably have to make concessions to nations such as Mexico, it also means that the ability of the oil importing debtors to service their debts has improved markedly. This was not the case in 1982 when both the oil exporting and the oil importing debtors were facing a bleak future. As a result, it should now be easier for the banks to grant concessions to Mexico, for instance, since it is unlikely that they will have to do the same for all debtors.

Lower Oil Prices: How Low and for How Long?

These benefits from lower oil prices are predicated upon a sustained drop in the price, that is, that oil prices will settle at a level $10 per barrel lower. Some analysts have expressed concern that the price drop will so stimulate oil consumption that the resulting increase in demand will push prices back up. They have also noted that the sharp slide in prices may force the OPEC member countries to restrict output, thus raising prices.

The imbalance between supply and demand of petroleum is nothing new; excessive OPEC production has been placing downward pressure on prices since 1982. Although a sharp rebound followed the four previous price collapses, it seems likely that this will not be the case this time around. In spite of expectations of stronger economic growth in the industrial nations, it is unlikely that demand will increase markedly.

Petroleum demand is still responding to the price increases of the 1970s. U.S. demand, which accounts for one-third of free world consumption, actually fell by two percent between 1982 and 1985, even though 1985 real GNP was 11 percent higher than in 1981, and real crude oil prices were 35 percent lower. Thus, industry experts do not expect final demand to exceed 16 million barrels per day during 1986. An analysis of the sources of demand – inventory build-up, the transportation sector, public utilities, industrial users, etc. – shows why demand is likely to remain weak.

As prices fell last month, stocks were quickly replenished, so inventory demand will remain weak. The move toward energy conservation prompted by the price increases of the 1970s has *permanently* reduced petroleum demand. For instance, two significant conservation measures were the move towards better insulated homes and more fuel efficient cars. It is unlikely that as a result of the drop in oil prices, new homes will be built with less insulation or that improvements in the fuel efficiency of new cars will be reversed.

Important sources of demand for petroleum in the United States are the transportation and utilities industries. Even though a reduction in gasoline and diesel fuel prices will stimulate demand from the transportation sector, improved fuel efficiency will dampen any increase. Since the nation's utilities have increased their use of gas and nuclear power, petroleum remains the swing fuel, used only during peak-load periods, and then only when gas is not available. Therefore, as long as gas prices remain competitive (and the deregulation of natural gas assures that declines in gas prices will accompany declines in oil prices), demand for oil from the utilities will remain substantially unresponsive to price changes. Industrial users of energy also reacted to the price increases of the 1970s by engaging in projects geared toward reducing energy consumption. Since most of those are now complete, it is unlikely that industrial consumption of oil will surge as a result of lower prices.

Because a substantial increase in demand is not forthcoming, a rebound in prices would only be likely if supply were curtailed. But OPEC's attempts of the past three years at maintaining production quotas have been unsuccessful. Debt-ridden oil exporters continue to pump as much oil as possible in order to service their debts, leaving Saudi Arabia to bear the burden of production cuts. Saudi Arabia has made it abundantly clear that it is no longer willing to play the role of swing producer. Industry analysts point to the fact that Saudi Arabian production costs are so low that it "generates as much net revenue by selling seven million b/d at $14 per barrel as by selling 3.5 million b/d at $27." Further, OPEC's efforts at cajoling non-OPEC producers to curtail production are bound to fail, since most non-OPEC oil producing nations are net oil importers who stand to benefit from lower oil prices. The only countries who might ally themselves with OPEC are Mexico and the Soviet Union. However, these two countries together export only about 2.5 million barrels per day of crude oil. Even if they cut their production by one half, their impact on world oil markets will be insignificant.

The Arguments Against an Oil Import Fee

In spite of the overwhelming evidence as to the benefits of the oil price decline, many will have us believe that we

must "protect ourselves" from it through the imposition of an oil import fee. Our detailed analysis of such a fee has determined that it would diminish the growth prospects of the American economy.

Table 2 summarizes the results of an econometric simulation of the impact of a $5 per barrel import fee performed by the consulting firm of Laurence H. Meyer & Associates (LHM&A). The static revenue increase resulting from the fee is estimated to be $10.1 billion in 1986 and $10.8 billion in 1987.

TABLE 2
ECONOMIC IMPACT OF A $5 PER BARREL OIL IMPORT FEE
(percentage difference from base unless otherwise indicated)

	1986	1987
Real GNP	−0.2	−0.5
Consumption	−0.2	−0.4
Nonresidential Investment	−0.3	−0.7
Residential Investment	−0.4	−0.7
Civilian Employment	−0.1	−0.3
Civilian Unemployment Rate (1)	+0.1	+0.2
Consumer Prices (1)	+0.6	+0.2
Implicit GNP Deflator (1)	+0.5	+0.2

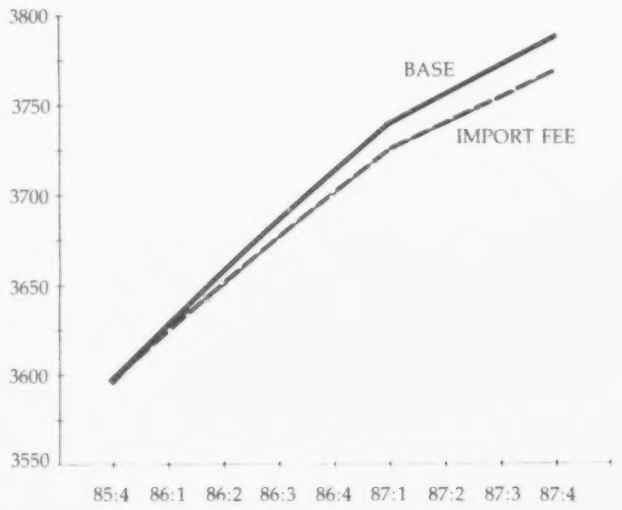
(1) Percentage point difference.

Source: Laurence H. Meyer and Associates, from a special analysis prepared for LHM&A clients.

Enactment of such a tax would increase inflation, thus lowering overall economic activity and partially offsetting the gains stemming from the slide in oil prices. The rate of growth of the consumer price index is anticipated to be 0.6 percentage points higher in 1986 and 0.2 percentage points higher in 1987 than would otherwise have been the case. The analysis assumes that the Federal Reserve, realizing that the rise in inflation is due to the import fee and does not represent a renewal of inflationary pressures, provides enough additional reserves so as to maintain interest rates at approximately the same level as in the base simulation. If the Fed does not accommodate the new tax, however, the negative impact on the economy would be larger.

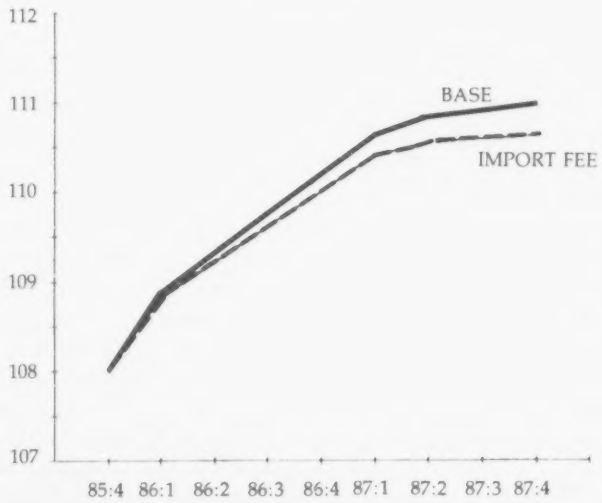
If the import fee is enacted, the *level* of real GNP can be expected to be 0.2 percent lower in 1986 and 0.5 percent lower in 1987 than would otherwise have been the case (see Chart 3). As a consequence of reduced economic activity and higher prices, consumer spending and residential and nonresidential fixed investment would also decline.

CHART 3
IMPACT OF A $5 PER BARREL IMPORT FEE ON GNP
(billions 82$)



Lower investment means that fewer private sector jobs will be created; civilian employment will fall by 0.1 percent and 0.3 percent in 1986 and 1987, respectively, compared to what would have been the case without the added tax (see Chart 4). As a result, the civilian unemployment rate will be 0.1 percentage points higher in 1986 and 0.2 percentage points higher in 1987.

CHART 4
IMPACT OF A $5 PER BARREL IMPORT FEE ON EMPLOYMENT
(millions)



The new tax reduces the size of the government deficit. However, the dynamic reduction ($17.9 billion over the two years), is $3 billion less than the static revenue

estimate. The deficit is not reduced by as much as expected because lower levels of economic activity and higher unemployment raise federal expenditures and reduce receipts. On the other hand, the increase in inflation resulting from the tax offsets part of the reduction in government receipts.

A Weaker Dollar

With all the attention being paid to the decline in oil prices, another piece of good economic news, the depreciation of the dollar, is being ignored. A falling dollar will improve the international price competitiveness of U.S. exports, thereby reversing the trend toward ever larger trade deficits. Moreover, the combination of a falling dollar and falling oil prices mitigates the inflationary pressures which result from the change in the value of the currency.

The factors behind the dollar's slide are various. Nevertheless, media accounts credit government intervention in international exchange markets with this development. In past issues of the OUTLOOK (see the September 1983 and April 1985 issues), we analyzed the factors behind the dollar's strength during 1980/1984 and voiced our skepticism about the effectiveness of foreign exchange intervention. Although the trade-weighted value of the U.S. dollar has declined by 25 percent during the last twelve months, it is our belief that intervention had very little to do with it. As history has repeatedly shown, the currency's value would not have continued on a downward path solely due to intervention. The fact that it has continued to decline points to underlying economic fundamentals which were already nudging the dollar downward seven months prior to the Group of Five announcement.

There are several reasons for the dollar's relative weakness. As can be expected, these are the reversal of most of the trends that had argued for its strength in the past.

The decline in the dollar's value, which began in February 1985, was prompted by expectations of relatively stronger growth overseas. While the dollar was appreciating, economic growth was proceeding at significantly stronger rates in the United States relative to our trading partners. Last year, however, the economies of our major trading partners began to improve markedly, while signs of weakness were apparent in the United States. Now, although the outlook for the U.S. economy has improved, the economies of major nonoil producing countries, such as West Germany and Japan, will benefit relatively more than the U.S. Moreover, because oil is priced in dollars, these nations stand to benefit even more from the oil price decline now that their currencies are strengthening against the dollar. Improved growth abroad increases the attractiveness of investment there relative to investment in the United States. This increases the demand for other currencies and reduces the demand for dollars and thus results in the appreciations of the mark and the yen.

Relative inflation trends have also been reversed. Although inflation has been on a downward path in all the major industrial nations, U.S. inflation was decelerating at a relatively faster pace during the early 1980s. During the past year, however, the rate of growth of consumer prices has fallen more rapidly in West Germany and Japan than in the United States. For example, in West Germany, the rate of growth in consumer prices fell by 0.8 percentage points during the past twelve months, while Japanese inflation has decelerated by 0.9 percentage points. In the United States, on the other hand, there has been no significant change in the rate of inflation during the past twelve months.

This discrepancy in relative inflation rates should widen during the next two years. The appreciation of other currencies against the dollar means that inflation in those countries should decelerate as the price of imported goods falls and foreign competition in domestic markets pushes domestic producers to lower their prices in order to remain competitive. At the same time, the opposite will be happening in the United States since a lower-valued dollar implies higher prices for imported goods and services.

During the early 1980s, relatively higher real interest rates in the United States increased the attractiveness of holding dollar-denominated assets, thus raising the demand for dollars and contributing to its appreciation. This trend has now been reversed. The real interest rate differential has also moved in a direction which will tend to weaken the dollar. In March 1985, real U.S. interest rates were 0.6 percentage points higher than those in West Germany and 3.7 percentage points higher than in Japan. Today, despite the recent reductions in prime lending rates in Japan, West Germany and the United States, U.S. real interest rates are 1.2 percentage points *lower* than the West German equivalent and only 2.2 percentage points higher than the Japanese. As a result, dollar-denominated assets are losing their attractiveness while yen- and mark-denominated assets are increasing theirs. This increases the demand for yen and marks while reducing the demand for dollars, leading to the appreciation of the former currencies and the depreciation of the latter.

Finally, the large U.S. trade deficit should begin exerting downward pressure on the dollar, since a strong U.S. demand for imported goods and services means that the U.S. is supplying dollars to the world economy. However, over the past few years, this supply of dollars was not sufficient to satisfy the demand which stemmed from the very attractive rate of return of dollar-denominated assets.

But now that both inflation and interest rate considerations should place downward pressure on the dollar, our large trade deficit should help further this trend. As a result, we expect the dollar to continue to depreciate, albeit at a more moderate rate. The trade-weighted value of the dollar is anticipated to fall by 11 percent during 1986 and five percent during 1987. This decline would place this index of the dollar's value at about the level it was in 1981 when the appreciation began.

Impact of the Dollar's Depreciation

Dollar depreciation affects the national economy by changing the prices of imports and exports. That is, a lower valued dollar reduces the foreign currency value of our exports, improving their competitiveness and raising foreign demand for our goods and services. At the same time, the dollar value of imported goods rises as the dollar depreciates. The effect is to increase U.S. exports and reduce imports, thus improving our trade balance and boosting national output, income and employment. The negative side effect, of course, is increased domestic inflation as imported goods become more expensive and as foreign competition in domestic markets subsides.

This price effect depends on the magnitude of the dollar depreciation and the extent to which it is "passed through" to prices of exports and imports. Earlier last year, it had been argued that foreign suppliers would limit price increases in order to maintain the market shares that they had been able to garner during the past five years. Further, it was noted that their profit margins were sufficient to allow for this price restraint. As the dollar's value has continued to fall, and as it has become evident that the recent decline is not temporary, the price of imports has increased, in some cases, quite substantially. Imported products, from Japanese television sets, to German cars, to French wines, have all experienced price increases in the past few months. Estimates place the average "pass through" at 60 percent of an exchange rate change; that is, foreign producers have, in the past, absorbed only 40 percent of the price changes due to exchange rate fluctuations.

The increase in the overall price level resulting from the depreciation of the currency depends on monetary policy. A rise in the price level can only be accommodated by an increase in money supply, a decline in money demand, or a decrease in real output. According to a Federal Reserve study, the impact of domestic currency depreciation, assuming that the Fed accommodates a one-time increase in the price level, but not a continuing higher rate of inflation, shows that for a 10 percent depreciation, consumer prices rise by 0.75 percent in the first year and 0.75 percent spread evenly over the second and third years. But because of the lags involved between changes in the value of the currency and their impact on domestic inflation, the U.S. economy was still experiencing the effects of previous appreciation during 1985. The extent to which inflation will rise during the next two years depends on the future path of exchange rates as well as on other factors such as capacity utilization, productivity growth, wage demands, oil prices and monetary policy.

A lower valued dollar spells welcome relief for many of our nation's industries since it will improve their price competitiveness in international as well as domestic markets. As a result, U.S. exports should increase and imports decline, thereby reducing the trade deficit. However, import volumes do not respond immediately to changes in import prices; thus, the initial effect of depreciation is to raise the dollar value of imports. Research shows that, in the case of the United States, this effect is not strong enough to result in a deterioration in the trade balance, yet it is sufficient to result in significant lags between a change in the value of the currency and its impact on the trade balance. Estimates place the length of this lag at somewhere between 12 and 18 months following the initial decline in the currency's value.

Nevertheless, there are some signs of improvement in the industrial sector which can be traced to the dollar's decline. As foreign competitors begin to raise their prices, American firms are winning more orders at home as well as abroad. The industrial production data is reporting increased activity in several industries. During 1985, output in the transportation sector rose by 8.8 percent. Exports of transportation equipment rose by 10.8 percent in November 1985 compared to its year-earlier level, while the motor vehicles and parts component enjoyed an increase of 7.1 percent during the same period.

Declining Dollar and Oil Prices: A Net Plus

In the short run, concerns about sharply accelerating inflation due to the dollar's decline have been rendered moot by the offsetting effect of the decline in oil prices. This month's forecast assumes that the price of imported oil averages $14 per barrel and the dollar drops by 11 percent during 1986. Unit labor costs are expected to rise only moderately as labor productivity improves. Since the nation's productive capacity is not being fully utilized (capacity utilization stands at only 80.6 percent in the manufacturing sector), this combination of forces argues for a further deceleration in consumer price increases in 1986 (see Table I). Consumer prices are expected to rise in 1987 as oil prices stabilize at a lower level.

Real exports rose by 7.4 percent during the last quarter of 1985 following declines of 11 percent and five percent during the second and third quarters, respectively. This end-of-year improvement was not sufficient, however, to offset the continued strength in the real value of imports, which rose by 19 percent in the fourth quarter. As a result real net exports deteriorated by $14 billion during 1985's

TABLE I
UNITED STATES ECONOMIC OUTLOOK 1986-1987
Prepared by the U.S. Chamber of Commerce
(Percent change from previous period at seasonally adjusted annual rates.)

	QUARTERS									YEARS			
	Actual			Forecast						Actual		Forecast	
	85:2	85:3	85:4	86:1	86:2	86:3	86:4	87:1	87:2	1984	1985	1986	1987
GROSS NATIONAL PRODUCT													
Real GNP	1.1	3.0	1.2	3.9	4.7	6.6	7.3	5.8	4.0	6.8	2.3	4.0	5.0
Consumption	2.6	4.6	0.1	3.4	3.6	4.5	4.8	2.9	2.8	5.3	3.3	3.1	3.5
Residential Investment	7.1	8.5	6.4	18.8	19.0	4.6	-.6	-1.0	-.7	12.2	1.8	11.3	.9
Nonresidential Investment	12.5	2.4	10.0	4.5	8.0	10.0	13.1	9.2	7.6	19.8	9.6	7.6	9.6
Equipment	16.9	3.0	10.4	7.6	10.8	12.5	15.2	10.6	7.4	21.5	8.6	9.8	10.7
Structures	5.2	1.2	9.2	-1.2	2.9	5.4	9.1	6.5	8.1	15.6	11.6	3.6	7.4
Exports	-10.9	-5.1	7.4	8.2	16.2	14.3	19.1	18.4	17.6	4.7	-2.9	7.9	17.4
Real Net Exports	-101.1	-119.8	-134.0	-133.5	-124.8	-109.1	-92.6	-81.5	-68.4	-85.0	-106.7	-115.0	-62.5
Imports	18.2	12.8	18.6	5.5	4.4	-2.1	.9	5.4	3.7	27.0	2.4	7.9	3.0
Government Purchases	2.1	37.3	16.1	-16.9	-16.7	-3.4	.0	-.3	-1.2	3.5	9.8	-.9	-2.1
Final Sales	1.2	5.0	2.1	2.3	3.8	5.8	6.6	4.2	4.1	6.0	4.0	3.5	4.8
Change in Business Inventories (82$B)	15.1	-1.8	0.1	6.6	14.9	21.6	28.8	44.0	44.1	24.8	7.3	18.0	45.2
Industrial Production	2.0	3.1	1.4	8.4	7.2	11.8	13.9	9.8	6.0	10.6	2.5	6.5	9.3
New Car Sales (total, mill.)	10.9	12.4	10.3	11.0	11.7	11.7	11.7	11.4	11.8	10.4	11.1	11.5	11.8
New Domestic Car Sales (mill.)	8.2	9.4	7.0	8.0	8.3	8.3	8.9	8.5	8.2	8.0	8.9	8.4	8.1
New Housing Starts (mill.)	1.74	1.69	1.75	1.97	1.99	1.97	1.95	1.95	1.95	1.80	1.73	1.97	1.95
EMPLOYMENT, WAGES AND PRICES													
Civilian Unemployment Rate (%)	7.3	7.2	7.0	7.0	6.7	6.4	6.0	5.8	5.6	7.5	7.2	6.5	5.5
Compensation	4.1	3.7	3.7	4.9	3.1	3.2	3.5	4.8	4.3	4.2	3.9	3.7	4.1
Productivity	1.0	0.5	-1.9	.3	2.1	3.1	3.2	1.8	.9	2.7	-0.2	.8	2.0
Unit Labor Costs	3.1	3.2	5.6	4.6	1.0	.1	.3	2.9	3.4	1.4	4.1	1.5	3.3
Consumer Price Index	4.3	2.3	4.2	1.5	1.7	3.2	4.0	5.1	4.9	4.3	3.5	2.7	4.4
Implicit GNP Deflator	3.3	2.9	3.3	3.5	2.0	2.1	2.8	3.7	4.3	3.8	3.3	2.9	3.5
Prime Interest Rate (%)	10.2	9.5	9.5	9.2	8.8	8.7	8.7	8.7	8.3	12.0	9.9	8.9	8.4
3-mos. Treasury Bill Rate (%)	7.5	7.1	7.2	6.8	6.3	6.4	6.5	6.4	6.1	9.5	7.5	6.5	6.2
Corporate Bond Rate (%)	11.6	11.0	10.6	9.7	9.3	9.3	9.1	8.7	8.4	12.7	11.4	9.4	8.3
Real Personal Disposable Income	8.3	-4.6	2.5	5.0	3.2	2.7	2.9	3.8	1.5	6.7	1.5	3.4	2.1
Profits from Current Production ($B)[1]	205.8	221.7	224.2	232.0	242.0	256.0	272.0	283.0	298.0	195.9	213.0	250	304
GOVERNMENT FISCAL POLICY ($B)[2]													
Unified Receipts										666.0	736	793	862
Unified Outlays										842.0	937	990	1015
Unified Deficit										-176.0	-201	-197	-153

[1]After-tax corporate profits with inventory valuation and capital consumption adjustments.
[2]Unified budget figures on a fiscal year basis.

SOURCE: U.S. Chamber of Commerce, Forecasting Section, using the Washington University model of the U.S. economy.

FORECAST ASSUMPTIONS

The March forecast assumes that spending cuts along the lines of the Gramm-Rudman-Hollings Act's requirement are enacted in FY 1986 and FY 1987. However, the cuts fall short of the Gramm-Rudman-Hollings deficit reduction goals. Tax increases or reform are not anticipated. The nation's money supply (M1) is assumed to grow by 8.5 percent in 1986 and 7.3 percent during 1987. The trade weighted exchange value of the dollar falls by 11 percent during 1986 and 5 percent in 1987. The price of imported oil averages $14.40 per barrel in 1986 and $15.00 in 1987. The federal minimum wage is not expected to increase.

last quarter. The improvement in U.S. exports is expected to pick up momentum during this quarter and next, however, it is not anticipated to be enough to result in a significant turnaround in net exports until mid-year. During the latter half of 1986 and 1987, the benefits of the dollar's decline and the expansion in world trade should contribute to significant improvements in our trade balance, which, in turn, should boost national output and employment.

Activity in the residential investment sector is expected to further buoy gross national product. The continuing improvement in housing affordability, in particular, the decline in mortgage interest rates, has already been reflected in sharp improvements in new housing starts. Interest rates on 30-year fixed mortgages have fallen below ten percent in some areas. As a result, following a 17.5 percent improvement in December, total new housing starts reached an annual rate of 2.1 million units in January, their highest level in almost a year. Presaging continued improvements in residential construction, building permits rose by 14 percent during the past twelve months.

Further improvements in personal income are the underpinnings for a healthy consumer sector. As the stock and bond markets continue to reach new highs, consumer wealth will keep rising. Moreover, the decline in interest rates improves the consumer's willingness to purchase durables and discretionary items usually bought on credit. It should be noted that the interest rate decline has filtered through to charges on revolving credit. Although the decline in credit card interest rates is, so far, an isolated occurrence, there are instances of interest rates as low as 14 percent, compared to the prevailing 18 percent to 21 percent rates. The decline in mortgage interest rates is likely to improve household cash flow as homeowners rush to refinance their mortgages at lower rates.

Despite this rosy assessment of the outlook, the dismal February employment data indicate that the first half of this year is not likely to come in with a bang. Unfortunately, just as the benefits of the dollar's depreciation have been a long time coming, it is also likely that the detrimental effects of the oil price decline will be initially larger than the benefits. A significant proportion of the increase in joblessness during February (see Trends in Commerce section), is attributable to layoffs in the oil industry in Texas.

A word of caution is in order regarding the February employment data. The national data were revised to include better estimates of the underground economy. In the case of the household employment data, on which the unemployment rate calculation is based, this includes improved estimates of immigration, including illegal immigrants, and emigration. The net result has been to raise the estimates for population. As a result the large increase in the unemployment rate reflects a one-time adjustment to the redefinition. The business establishment survey, on the other hand, points to continued employment gains during February.

The decline in interest rates, although not necessarily welcome by investors, significantly improves the economy's health through its impact on the federal budget deficit. Lower interest rates will spur economic growth thus expanding the tax base and increasing federal revenues. At the same time, outlays for interest charges, one of the largest, and until recently, a continuously expanding contributor to the federal debt, are reduced. The interest rate that the Treasury must pay on its three-month bills fell to 6.55 percent early this month. Thus, not only is the estimate for this year's deficit reduced, but the improvement feeds through to future years since a lower deficit means smaller-than-anticipated increases in the federal debt which, in turn, implies lower-than-anticipated outlays for interest charges on that debt.

IT'S TIME TO RESTORE PRESIDENTIAL BUDGETARY POWER

by
Cesar V. Conda and William P. Orzechowski*

The Gramm-Rudman-Hollings Act and the deficit targets it requires Congress and the President to reach is potentially the most effective spending reduction proposal ever enacted by Congress. To date, the Act has been a success. Its automatic sequestering mechanism has chopped nearly $12 billion from this year's federal budget which, in addition, lowers spending in future years by lowering the spending base for 1987. The credit markets have responded favorably, with rising bond and stock prices and lower interest rates, to the prospect of declining deficits. Wasteful and extravagant federal programs have been exposed and are now being cut.

To meet the requirements of the Act, the President submitted a budget proposal in February that makes the difficult choices necessary to cut nondefense spending. The President's major policy initiatives of program terminations, privatization, federalism, social service reforms, user fees and management reforms are realistic attempts to define the proper role of government.

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But the recent three-judge court ruling against Gramm-Rudman's automatic sequestering mechanism has eased the pressure on Congress to respond with a budget that prioritizes federal spending programs and cuts the waste and inefficiency from the bloated federal budget. As one relieved member of Congress put it, "Gramm-Rudman is now a toothless tiger." Indeed, the mere threat of indiscriminate across-the-board cuts in defense and non-exempt domestic programs was supposed to force Congress to make the hard political choices that they have so far avoided. This automatic "hammer" was designed to be a force for fiscal restraint.

Fortunately, there is now reason to believe that the Supreme Court may alter the initial negative opinion of the three judge panel. But if the panel's decision stands, the fallback mechanism throws the whole process back into the hands of Congress—where it has been for the last twelve years since the enactment of the Budget and Impoundment Control Act of 1974. Congress would have to approve the across-the-board cuts by a joint resolution which would then be sent to the President for his signature. In effect, independent action by either the House, the Senate or the President would nullify the entire Gramm-Rudman-Hollings process. If the automatic trigger fails to stand up to full judicial review, the budget process will be back to business as usual with no external restraints on congressional spending. The way to avoid this outcome is to restore some budgetary power to the Executive.

The Founding Fathers originally empowered the President to veto spending bills passed by Congress. However, the boundaries of Presidential discretion over the expenditure of funds has never been clearly defined. We know that from George Washington to Richard Nixon, the President has had the power to impound or refuse to spend money that Congress had appropriated. Moreover, Congress had no formal procedure to overturn such an action.

In the first recorded impoundment, Thomas Jefferson refused to spend $50,000 that Congress had appropriated for Navy gunboats on the Mississippi River. Early presidential impoundments were almost always routine, that is, they reflected managerial savings, or a change in conditions that required the cutback of a program. Curiously, it was Franklin Roosevelt who began the practice of policy impoundments, that is, impoundments which explicitly countered Congressional intent. During his tenure, President Roosevelt impounded half a billion dollars in public works funds. President Truman continued this practice by impounding funds for domestic spending and a supercarrier. President Eisenhower ordered cutbacks and stretch-outs in defense programs to keep the federal debt within its statutory limit. During their tenure, Presidents Kennedy and Johnson reduced projected spending by six percent and 5.4 percent, respectively, through the use of impoundments.

For the most part, Congress reluctantly accepted these impoundments and a constitutional crisis did not occur until the Nixon presidency. President Nixon pushed the boundaries of impoundment powers to their limit by exercising unfettered discretion in reducing and terminating federal programs explicitly against congressional intent. In one year alone Nixon impounded almost $18 billion in funds voted by Congress. In Congress' view, Nixon's use of impoundment overstepped the bounds of executive authority. In response, Congress moved in a diametrically opposed direction by enacting the Budget Act of 1974 which repealed the Presidential prerogative to impound funds and left him with the considerably less effective rescission and deferral authority, thereby debilitating the executive's authority over the budget process.

The President's powers to rescind and defer appropriated funds is a clumsy and ineffective form of executive budget control. As the term indicates, a deferral merely postpones spending for which funds have been appropriated. Moreover, the House or Senate may force the President to spend the money immediately despite his deferral. A rescission of appropriated funding or an outright executive refusal to spend money must be explicitly approved by Congress within 45 days. However, if Congress simply does nothing, the money must be spent as originally intended. As a consequence, President Reagan has been able to reduce federal spending by only 1.3 percent through the use of rescissions and deferrals. In fact, during the past three years, President Reagan proposed rescissions totaling $4 billion, but only $221 million, or a paltry 5.4 percent of the total, has been approved by Congress.The combination of severe limits on Presidential impoundment and the use of omnibus appropriations bills which further dilute the President's powers has been the underlying cause of the explosive growth in federal spending. Since 1974, Congress has had almost unfettered power over the purse, resulting in a federal debt larger than that accumulated by all of the Presidents from Jefferson to Nixon combined. The enactment of Gramm-Rudman-Hollings was an oblique attempt to restore some form of impoundment authority to the President. While the partial across-the-board nature of the automatic sequester limits Presidential discretion, it restores an important external check on Congress' tendency to overspend; a check that up to 1974, had existed for almost 170 years.

To put teeth back into what remains of the Gramm-Rudman-Hollings process, Congress must give greater budgetary power to the President. This can be accomplished through the use of the line-item veto or enhanced recission power. These mechanisms can be tempered to limit executive discretion but at the same time serve as an

effective force for fiscal discipline. They can be coupled with the Gramm-Rudman-Hollings targets or they can be used to enforce budget resolutions that approximate those targets.

In 1983, Senators William Armstrong (R-CO) and Russell Long (D-LA) submitted a proposal that would have forced Congress to stay within its own budget resolution. It would accomplish this by requiring that appropriations spending not surpass the quarterly debt-ceiling limits set by Congress as part of the yearly budget resolution. The president would be empowered to rescind spending up to a limit of 20 percent of total appropriated funds in order to stay within the debt-ceiling limits. The Long-Armstrong proposal was tabled by a vote of 49 to 46. In today's deficit-conscious political climate, such a measure probably would enjoy even more support.

Senator Armstrong also submitted a proposal which would require Congress to vote explicitly for or against a rescission order within 45 days or risk having the funds permanently withheld. This would have strengthened the President's rescission power without infringing upon Congress's ultimate authority in spending matters. According to the American Law Division of the Library of Congress, this proposal is constitutional and conforms with recent Supreme Court doctrine on the legislative veto.

Congress should, in the very least, grant the President a limited form of line-item veto power. This power would be activated only if the spending totals in omnibus appropriations bills or continuing resolutions are estimated to breach the spending ceilings set forth in the budget resolution. If Congress keeps within the ceilings that it sets for itself, the President's line-item veto power would not come into effect. To get around this, Congress may decide not to enact a budget resolution at all, and to add an extra incentive to produce a budget resolution, the previous year's resolution levels could be used as a guide. Several variations on the line-item veto are possible: Congress could let these powers expire after two or three years; cap the total reductions in a single year; or require equal reductions between defense and nondefense spending.

Most members of Congress are sincere in their desire to meet the goals of Gramm-Rudman-Hollings. Recent economic events suggest that the Gramm-Rudman-Hollings deficit targets can be easily achieved through spending reductions alone. The continued drop in the price of imported oil will spur higher-than-expected GNP growth resulting in higher tax revenues. In addition, lower interest rates and last year's cuts in defense spending have already placed the deficit on a declining path. Both the Congressional Budget Office (CBO) and the Office of Management and Budget (OMB) forecast a 50 percent decline in the deficit by 1991, to about $100 billion, without any changes in spending or tax policies. Consequently, the magnitude of required spending reductions is smaller than had been previously estimated. But it is institutionally impossible for Congress to do the job of cutting spending alone. Meeting the Gramm-Rudman-Hollings deficit ceilings will involve some politically painful cuts in popular domestic programs. Why not share some of the direct burden with the President? He is willing, but not able. In an election year, Congress can escape some of the blame for cutting spending if it restores some form of presidential budgetary power.

Perhaps Congress can learn from history. When deficits appeared in 1931 for the first time in ten years, Congress debated the same issue of granting the President statutory impoundment authority over and beyond previous practices. At that time, Pennsylvania Senator David Reed told his colleagues, "The only way by which we will get results is by putting the power into the hands of somebody who will assume the responsibility and use it... if we are to get economies made, they have to be made by someone who has the power to make the order and stand by it. Leave it to Congress and we will fiddle around here all summer trying to satisfy every lobbyist, and we will get nowhere." This advice is just as sound and applicable today as it was in 1931.

PRESSURE FOR CHANGE IN FINANCIAL MARKETS

by
Rajni Bonnie Ohri

The market forces creating the pressure for change in the U.S. financial system continue to be strong and numerous. Unfortunately, the process by which such change will be handled from a legislative, regulatory, and judicial perspective have been further confused by recent developments.

The financial industry has already been shaken by such developments as the collapse of the private deposit insurance funds in Ohio and Maryland, the failure of several government securities dealers, a record number of bank and thrift failures, and questions about the solvency of the Federal Savings and Loan Insurance Corporation (FSLIC). This year, lawmakers can expect to grapple with continuing problems in the industry, including more questions about the adequacy of the FSLIC fund, the Federal Home Loan Bank Board's (FHLBB) resulting inability to close insolvent savings institutions, the growing strains placed on money center banks by their international debt load, and the large number of small community banks driven to the wall by difficulties in the agricultural economy.

In addition, the decision of the U.S. Supreme Court to hear the Citicorp suit concerning the validity of reciprocal regional banking agreements among states has created uncertainty about the geographical expansion of banking via interstate mergers. The geographical question has been further complicated by the recent approval of a number of nonbank banks by the Comptroller of the Currency, and functional questions have become confused by a Federal Deposit Insurance Corporation (FDIC) decision to allow state-chartered banks extensive securities underwriting powers. All these factors, plus free-market forces have served to put pressure on Congress to bring some order to this confused scenario.

First Signs of Change

Today, in what is called by many a "financial free-for-all," brokerage firms can set up shop in department stores, banks sell securities and insurance companies buy banks. At the same time, legal barriers that have kept banks from crossing state lines are slowly, yet inexorably, being eroded.

The first signs of these changes in the U.S. financial sector appeared with the Financial Institutions Deregulation and Monetary Control Act of 1980. This act generally encouraged greater competition within the banking industry, while at the same time extended the Federal Reserve's control over the money supply and subjected all commercial banks, savings and loans, savings banks and most credit unions to federal regulation. Although the 1980 Act did not specifically address the interstate banking issue, it brought important changes: As of January 1, 1981, all banks were permitted to offer interest-bearing checking and NOW accounts; ceilings on deposit interest rates were to be phased out by the end of 1985; federally chartered savings and loans and savings banks were allowed to make more consumer loans, offer credit cards and invest in commercial paper.

Over the same period, there was an explosion in services offered by financial institutions. Consequently, the need for legislative reform of the functions and regulations involving depository institutions brought about the passage of the Garn-St. Germain Depository Institutions Act of 1982. The purpose of this legislation was to revitalize the housing industry by strengthening the financial stability of home mortgage lending institutions and ensuring the availability of home mortgage loans. In effect, the 1982 Act expanded thrifts' lending powers and allowed banks and thrifts to offer money-market deposit accounts.

In spite of these changes, many of the laws governing banks remain essentially unaltered. The McFadden Act of 1927, the basic federal branch banking law, effectively prevents national banks from interstate branching by limiting them to branching only inside their home states. The Douglas Amendment to the Bank Holding Company Act of 1956 (BHCA) prohibits interstate banking through means of a bank holding company acquiring banks in another state unless the state explicitly authorizes them. Initially intended to give national banks the same branching powers as state-chartered institutions, these restrictions still remain operative in the belief that they help avoid undue concentration of banking powers and preserve local banks and credit markets.

Nonbank Banks on the Move

One of the strongest movements in the banking industry today is the expanding role of the "nonbank banks." Competition from this group has been instrumental in forcing the general move toward interstate banking, and it has been helped along by the BHCA that defines a bank as an institution that accepts demand deposits and makes commercial loans. This definition allows nonbank banks to exist and operate outside the bank regulatory framework as long as they offer only one, not both of these services. It has opened the door for financial companies like American Express, Merrill Lynch, Sears and others to offer various financial services and to establish banking units on a multistate basis.

Nonbank banks have become a major bone of contention between the bank regulatory agencies, especially between the Federal Reserve Board (FRB) and the Comptroller of the Currency. In addition to receiving chartering authority from the Comptroller, the bank holding companies must also receive Fed authority to acquire the limited service banks. The FRB essentially opposes nonbank banks because it is concerned that the proliferation of such institutions undermines the BHCA's limitations on interstate banking and the separation of banking and commerce. In a January 22 decision, the U.S. Supreme Court ruled that the FRB had overstepped its authority when it tried to stop the formation of nonbank banks by redefining the term "bank" under the BHCA (FRB vs. Dimension Corporation). In response to the court decision, the FRB has put considerable pressure on members of Congress to adopt legislation that alters the statutory definition of the term "bank" under the BHCA. The House Banking Committee has already approved legislation (H.R. 20) that would close the nonbank bank loophole by redefining the term "bank" to include any institution insured by the FDIC, and grandfathers institutions that had acquired nonbank banks on or before May 9, 1984.

According to a survey by the *American Banker*, about 60 nonbanking companies operate 65 banks, and more are coming on line. Their parent companies, for the most part, are already in the financial services field: Beneficial Corporation, T. Rowe Price, Merrill Lynch, Prudential

Bache Securities. Companies such as 3-M and Ford also operate some form of bank. Sears, through its financial services subsidiary, Dean Witter Reynolds, has acquired several banks, including Greenwood Trust Company of Delaware and Sears Savings Bank (a $6.1 billion thrift in California), and operates over 300 financial service centers in Sears stores. The company is now on the verge of releasing the Discover card, designed to compete with Visa and Mastercard.

Interstate Banking Gains Momentum

Recent decisions in the courts and in Congress are also clearing the way for interstate banking. In June 1985, the Supreme Court upheld the right of states (under the Douglas Amendment to the BHCA) to agree to interstate bank mergers among themselves through regional compacts. In addition, the House Banking Committee approved legislation (H.R. 2707) that would lead to nationwide interstate banking. Treasury Secretary James Baker has also endorsed the House interstate banking bill, reaffirming the Reagan Administration's support for nationwide interstate banking. But, even as the momentum toward interstate banking grows, there is still no clear consensus among legislators, regulators, or even bankers on how to ensure that interstate banking will maintain a safe, efficient and competitive banking system.

The development of regional banking compacts, which empower banks from states of a defined region to acquire or establish banks in other states within the region, is causing concern among legislators and trade associations. Major banking trade groups, such as the American Bankers Association, although endorsing the concept of regional interstate banking, oppose the idea of including a national "trigger" provision. (A national trigger is a specific date by which nationwide banking would be required among states that had already approved regional interstate banking compacts). This provision is included in H.R. 2707, which mandates interstate banking on July 1, 1990 among all states that had approved regional interstate banking arrangements at least two years prior to that date.

Debate has also been growing over the issue of regional versus full interstate banking. Proponents of regional banking (and no trigger date) contend that while the development of strong regional banks capable of competing with huge money center banks should be encouraged, full interstate banking would lead to a banking oligopoly, the domination of the national market by a few banks. Others contend that full interstate banking is essential if banks are to meet the fierce competition of national non-banking firms such as Sears. They regard the regional banking concept as just another means for constructing artificial geographic barriers to entry which foster local and regional monopolies.

At the heart of this debate is the issue which led to the prohibition of interstate banking in the first place—will the authorization of interstate banking lead to increased concentration and decreased competition in banking? Many trade associations, such as the Independent Bankers Association of America, believe that greater concentration of financial resources at the national level will result, and are thus opposed to interstate banking in general. However, others contend that it is important to recognize that increased national concentration does not necessarily imply reduced competition at the local market level. Indeed, the elimination of geographical barriers to entry should result in more competition, greater efficiency, and more diversified services in the market.

Although the House has moved forward on these issues, Senate Banking Committee Chairman Jake Garn (R-Utah) has yet to introduce legislation addressing either nonbank banks or interstate banking. He does plan to introduce comprehensive financial reform legislation, similar to S. 2851, a bill approved by the Senate last year but killed by the House committee. The financial reform bill, S. 2851, would have closed the nonbank bank loophole with a July 1, 1983 grandfather date and would have authorized regional interstate banking agreements with no national "trigger."

Federal Deposit Insurance Reform

Another motivating factor in moving toward interstate banking has been the recent failure of many thrift institutions and a desire to remedy these failures as inexpensively as possible. One way to accomplish this is to allow outside banks to buy the failing institutions.

Currently, Congress and the regulators are studying two major problems inherent in the deposit insurance system: difficulties of operating the system as a whole, and perceived inequities affecting insured institutions. As it is presently structured, the federal deposit insurance system is thought to encourage greater risk-taking among some of the institutions it insures. This situation arises primarily because of two factors. First, all institutions are treated alike for purposes of insurance coverage and premiums, even if their risk characteristics differ. Thus, the federal deposit insurance system arguably does not provide sufficient direct incentives to discourage excessive risk-taking by insured financial institutions. Second, because of the way failures of most depository institutions have been handled in the past several years, most depositors have been made whole even if their funds on deposit have exceeded the explicit insurance coverage. In this case, the insurance system provides few incentives for depositors to assess the financial conditions of the institutions in which they place their funds.

The FHLBB has advanced legislation (H.R. 1680 and S. 759) to revamp the thrift insurance structure by requiring those thrifts which engage in activities that the agency considers risky to pay higher insurance premiums and to

impose higher premiums on S&Ls with low net worth levels. That legislation and another bill submitted by the agency (H.R. 2444 and S. 1167) would also give the agency stronger supervisory powers, enable the FHLBB to prohibit certain activities, establish a "thriftness" test that requires federally insured institutions to keep a major portion of their portfolios in home mortgage loans, and make further changes in thrift laws. However, the FHLBB's legislation does not reach the heart of the FSLIC's problem, namely its lack of funds. The Bank Board has yet to suggest a clear plan for injecting more money into the fund or some method of taking care of the insolvent S&Ls.

High on the list of possible solutions to the FSLIC's problems is to encourage nondepository institutions to acquire problem thrifts. This technique would inject new management and capital into the thrift industry and would reduce the FSLIC's problems by allowing it to dispose of problem institutions without spending an excessive amount of funds. Commercial companies, such as automobile manufacturers and insurance companies, already may acquire thrifts under the Unitary Savings and Loan Holding Company Act, but in practice, the FHLBB has discouraged some types of commercial acquirers, especially securities firms.

Alternatively, the Treasury Department has suggested tapping the equity of the FHLBB and providing some type of stand-by line of credit such as that approved for the Farm Credit Administration. (The new law authorizes Treasury to inject funds into the Farm Credit System, subject to authorization of the assistance by Congress, if the system's capital and reserve resources are exhausted. It also mandates resource sharing within the system.) The U.S. League of Savings Institutions supports the idea that the FHLBB resources should be available to help with the FSLIC's problems. The National Council of Savings Institutions favors the idea of allowing nondepository institutions to acquire problem thrifts. If the FSLIC fund faces a financial emergency that does not allow one of these alternatives to be put into place, Congress may consider the idea of merging the FSLIC with the much larger FDIC insurance fund, a remedy that is strongly opposed by both the banking and thrift industries.

Securities Activities of Banks

High on the list of pressures prompting the deregulation debate further is the increase in securities activities of banks and bank holding companies. "Securitization" – the growing preference of corporations to borrow from the public instead of from the banks – has eroded the distinction between loans and securities, and diminished the commercial lending opportunities available to banks. In response, the banks are rapidly trying to chip away at 50 years of legislative separation between commercial banks, which previously concentrated on taking deposits and granting loans, and investment banks, which primarily engaged in the underwriting, trading and sale of securities. With few exceptions, the two arms of finance have been legally separated since the Glass-Steagall Act was passed.

The Glass-Steagall Act of 1933 stipulates that commercial banks may only underwrite general obligation bonds of state and local governments and, through their trust departments, may purchase and sell stock and securities. Specifically excluded, however, is the underwriting and dealing of corporate long-term debt and stocks by commercial banks directly, or in the case of Federal Reserve member banks, through affiliates. The Act has also prevented securities firms from encroaching on markets served by commercial banks. These restrictions, however, do not exclude banks from engaging in all securities activities. U.S. commercial banks are expressly authorized to underwrite and deal in U.S. government securities and those securities that are the general obligations of states and municipalities. Moreover, a number of foreign banks – those grandfathered under the International Banking Act of 1978 – can engage in both investment and commercial banking in the U.S. And, in foreign markets, U.S. commercial banks can underwrite and deal in corporate and other types of securities through offshore affiliates or subsidiaries.

In the debate regarding the issue of separating commercial banking from investment banking, several potential conflicts of interest have been identified. Glass-Steagall opponents argue that depository institutions are not significantly different from other providers of financial services, such as securities brokers, investment bankers and insurance companies. Each offers products or services that complement or are substitutable for each other. Proponents of deregulation hold that any barriers preventing financial firms from entering each other's businesses should be dismantled, enabling all financial firms to compete on a 'level playing field.' They contend that the Act's only function is to protect investment bankers from competition, thereby reducing the efficiency of the capital markets, harming both savers and investors. In addition, to prevent possible abuses, bankers feel it is not necessary to separate investment and commercial banking since other laws and regulations provide adequate protection against abuses.

On the other hand, those who favor Glass-Steagall's retention argue that banks should be distinguished from other financial and nonfinancial providers and that the government, through the regulatory agencies, should assure their safety and soundness. The Securities Industry Association, in particular, contends that the elimination of the Act would result in inadequate customer protection, increased concentration of financial

powers, and a movement toward European-style universal banking with its bias against entrepreneurship. In addition, Glass-Steagall proponents allege that because banks possess advantages such as entry restrictions, deposit insurance, and access to the FRB's discount window, they would have a competitive advantage over other suppliers of financial services unless reciprocal entry is allowed.

The current prospects for the abolition of the Glass-Steagall Act are unclear. In recent sessions of Congress, numerous draft bills have been debated. These bills have incorporated provisions allowing banks to offer open-ended mutual funds and to underwrite both municipal revenue bonds and mortgage-backed securities (S. 2851), proposals which represent significant modification of Glass-Steagall. However, no serious proposal has been made to allow banks into domestic corporate securities underwriting, despite the apparent success of large U.S. banks in underwriting corporate (dollar-denominated) Eurobonds.

The latest development in the legal battle between the banking industry and the securities industry involves the incursion of Bankers Trust into the lucrative commercial paper market (short-term corporate debt used to finance seasonal and other short-term operating needs), an area traditionally reserved for securities firms. A recent federal court decision, however, ruled that Bankers Trusts' commercial paper operation was not permitted under the Glass-Steagall Act as it posed potential conflicts of interest that could provide a financial incentive to distort lending practices. Several other banks, including Chemical and Bank of America, also have commercial paper operations, but have no plans to suspend them. The FRB has not yet decided whether it would take action to prevent banks from underwriting commercial paper.

In addition, last summer the Securities and Exchange Commission (SEC) ruled that banks offering brokerage services must conform with SEC requirements, implying that banks will have to register with the SEC, meet capital requirements and set up separate brokerage subsidiaries in order to continue to offer securities. The American Bankers Association predicts that many of the 2,000 banks providing brokerage services will discontinue rather than pay the extra costs involved in meeting the SEC's demands.

Conclusion

As has been the case for the past three years, state legislators, the regulatory agencies, and the courts are likely to be more active in setting the rules for the financial industry than Congress. However, there are a few issues that Congress will be forced to resolve in 1986. Titles I and II of the 1982 Garn-St. Germain Act will expire April 15, and Congress must decide whether to extend them. These provisions authorize the FHLBB to issue net worth certificates to savings institutions with low net worth and give both the Bank Board and the FDIC power to arrange emergency interstate and interindustry mergers of failing institutions. The 1982 law gives the FDIC and FHLBB authority to seek merger partners across state and industry lines for failed institutions with more than $500 million in assets. The FDIC has asked Congress to lower that threshold to about $200 million or to allow the agency to use the emergency authority for any of the 10 largest banks in any states.

Everyone seems to agree on one thing: any legislative action will redefine the term "bank" and close the nonbank bank loophole. Existing institutions would be grandfathered, leaving a number of nonbank banks in business. Although Senate Banking Chairman Jake Garn agrees with House Banking Chairman Ferdinand St. Germain that the nonbank bank loophole should be closed, he refuses to accept single-purpose, loophole-closing legislation. Garn believes that banking organizations should be able to offer a broader range of financial service products, whereas St. Germain maintains that a re-regulation course would better serve the consumer.

TRENDS IN COMMERCE NOTES ON TABLE II MARCH 1986

by
Martin Lefkowitz *

Gross National Product (GNP)—The Department of Commerce's revised estimate of Gross National Product—the value of the output of goods and services—shows that the inflation-adjusted growth rate for the fourth quarter was 1.2 percent, half the pace previously estimated. Real GNP growth over the four quarters of 1985 was 2.3 percent, a substantial drop from 1984. The fourth quarter revision reflected a sharp deterioration in the nation's trade deficit and lower inventory investment. The plunge in new car sales during the fourth quarter resulted in a 0.1 percent decline in consumer spending compared to an increase of 4.6 percent in the third quarter. On the other hand, business inventories, business fixed investment, and government purchases rose substantially. Real business investment rose at a ten percent annual rate.

The Services Sector—Employment in service sector establishments jumped 294,000 in February and is now

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three million above its year-ago level. This compares with an increase of 187,000 jobs in the goods-producing sector over the last year. Over 94 percent of the job growth in the economy during the past year has been in services industries.

Consumer purchases of services dropped 0.3 percent in January as consumers responded to a 0.1 percent drop in income. Major domestic airlines reported that revenue passenger miles flown, that is, the number of passengers multiplied by the miles flown by each passenger, reached 19.8 billion in January, an increase of 10 percent from its year-ago level. For 1985 as a whole, major U.S. carriers reported an 11.3 percent increase in revenue passenger miles flown compared to 1984.

Money Supply–The nation's money supply–as measured by M-1, currency in circulation plus demand deposits–increased by 0.1 percent during January, virtually unchanged from the previous month. Money supply growth has slowed to an 8.3 percent annual rate in the latest three-month period, but is still 11.4 percent above its year-ago level, and remains considerably above the Fed's target range.

Employment–Civilian employment–as measured by the monthly survey of households–decreased by 394,000 in February.The civilian unemployment rate increased 0.6 percentage points in February to 7.3 percent. Almost two-thirds of the rise in unemployment was registered in three states–California, Texas and Illinois, whose performance reflects the impact of bad weather and falling oil prices. A quarter of the rise in unemployment was concentrated among Hispanics and in the farm sector. The number of nonagricultural payroll jobs–as measured by the monthly survey of business establishments–increased by 225,000 in February.

Prices–The Consumer Price Index for all urban consumers (CPI-U) increased 0.3 percent in January, the smallest monthly increase since September. This places the index 3.9 percent above its year-ago level. The slower inflation pace was mainly the result of smaller increases in the energy and food components. With oil prices continuing to drop sharply, experts predict that the February index should show no increase at all at the retail level.

Wholesale prices of finished goods decreased 1.6 percent from January to February and are 0.1 percent lower than their year-ago level. This was the largest one-month decrease since 1947. The major contributing factors were a 9.6 percent drop in finished energy goods and a 1.6 percent drop in food prices.

Crude goods prices fell 5.0 percent in February, following a 1.4 percent decrease in crude goods prices during January. The February fall was the largest monthly decline since September 1973. February crude material prices were 8.7 percent below their level of a year ago. All major categories, except construction materials, are below their 1985 levels. Crude energy materials fell 8.2 percent, foodstuffs and feedstuffs declined 3.6 percent, and other raw materials were down 3.0 percent.

Housing Starts–Privately owned housing units were started at a seasonally adjusted annual rate of 2,088,000 in January, an increase of 15.7 percent from the December level. The January figure was the highest since February 1984 and was 15.7 percent above its year-ago level. Most of the improvement in starts is attributable to steady declines in mortgage interest rates as both fixed and adjustable rate mortgages have fallen by about 1.5 percentage points over the past year. Building permits, an indicator of future activity in the home building industry, were virtually unchanged on a month-to-month basis, but were 14 percent higher than their year-ago level.

Industrial Production–Industrial production decreased by 0.6 percent in February, following a 0.7 percent jump in December, and was 2.5 percent above its year-ago level.

The capacity utilization rate in manufacturing increased to 80.6 percent in January from 80.5 percent in December. The increase occurred in motor vehicles and parts (2.8 percentage points) and petroleum products (4.5 percentage points). Manufacturing capacity rose 0.6 percent in the third quarter of 1985, up three percent from a year ago.

Productivity–Nonfarm business productivity fell 0.2 percent during 1985, the first annual decline since 1982. Business output rose 2.7 percent while hours worked increased 2.8 percent for the year as a whole. Manufacturing productivity rose 2.7 percent in 1985 and output in the manufacturing sector rose by 2.5 percent, while hours worked were down by 0.2 percent.

Interest Rates–After nine months at 9.5 percent, the prime interest rate fell to 9.0 percent on March 7th, 1.5 percentage points below the rate prevailing at this time last year. The prime lending rate is now at the lowest it has been since August 1978. Three- and six-month Treasury bill rates were both below seven percent in early March, and thirty-year Treasury bond rates dropped to nearly 8.0 percent, the lowest level in over eight years.

Business Failures and Formations–Dun and Bradstreet's Index of Business Failure indicates that business bankruptcies in 1985 were up by 6.4 percent as compared to 1984.

Dun and Bradstreet reported that 607,244 new business corporations were formed in the first eleven months of 1985, an increase of 4.3 percent from the same period in 1984. At the present rate, there will be over 660,000 new corporations formed in 1985 compared to 634,991 in 1984.

TABLE II
TRENDS IN COMMERCE

	Current Period		Previous Period	Year Ago	Percent Change From Previous Period	Percent Change From Year Ago
Population (Millions) [a]	Nov/85	240.1	239.9	237.9	0.1	0.9
Gross National Product ($B)	IV/85	4,061.1	4,016.9	3,825.5	1.1	6.2
Gross National Product (82$B)	IV/85	3,594.8	3,584.1	3,515.6	0.3	2.3
Money Supply (M1) ($B)	Jan/86	626.9	626.3	562.9	0.1	11.4
PEOPLE AND THEIR MONEY						
Personal Consumption Expenditures ($B)	Jan/86	2,667.0	2,677.6	2,510.3	−0.4	6.2
Personal Consumption Expenditures (82$B)	Dec/85	2,359.1	2,318.3	2,278.7	1.8	3.5
Disposable Personal Income ($B)	Jan/86	2,878.6	2,873.2	2,748.6	0.2	4.7
Disposable Personal Income (82$)	Dec/85	2,531.5	2,509.5	2,492.0	0.9	1.6
Personal Savings Rate (%)	Jan/86	4.0	3.4	5.7	0.6[b]	−1.7[b]
Civilian Employment (millions)	Feb/86	108.6	109.0	106.6	−0.4[c]	1.9[c]
Civilian Unemployment Rate (%)	Feb/86	7.3	6.7	7.3	0.6[b]	0.0[b]
Average Hourly Earnings	Feb/86	$8.72	$8.68	$8.49	0.5	2.7
Consumer Price Index (All Urban, 67 = 100) [a]	Jan/86	328.4	327.4	316.1	0.3	3.9
Purchasing Power of the Dollar (67 = $1.00) [a]	Jan/86	0.305	0.305	0.316	0.0	−3.5
Prime Interest Rate (%) March 7, 1986		9.0	9.5	10.5	−0.5[b]	−1.5[b]
Retail Sales ($)	Feb/86	117.3	117.4	112.1	−0.1	4.6
SERVICES SECTOR						
Employment in Services (Millions)	Feb/86	75.5	74.2	71.5	1.8	5.6
Consumer Purchases of Service ($B)	Jan/86	1,360.4	1,364.3	1,271.5	−0.3	7.0
Consumer Purchases of Service (82$B)	Dec/85	1,146.3	1,130.7	1,112.9	1.4	3.0
Domestic Revenue Passenger Mileage Flown Major Airlines (Billions) [a]	Jan/86	19.8	21.1	18.0	−6.2	10.0
BUSINESS PROFITS AND OUTPUT						
Nonfinancial Corporate Profits ($B) [a]						
Before Tax [a]	III/85	228.6	218.7	227.7	4.5	0.4
After Tax [a]	III/85	141.1	136.4	140.3	3.4	0.6
Industrial Production (77 = 100)	Feb/86	125.7	126.5	123.7	−0.6	1.6
Capacity Utilization Rate (Mfg.) (%)	Jan/86	80.6	80.5	80.7	0.1[b]	−0.1[b]
New Housing Starts (thou. units)	Jan/86	2,088.0	1,804.0	1,804.0	15.7	15.7
Net Business Formation (67 = 100) [a]	Jan/86	117.8	119.5	115.9	−1.4	−1.6
New Business Incorporations (Thousands)	Nov/85	54.8	57.6	53.5	−4.9	2.4
BUSINESS COSTS						
Unit Labor Costs (nonfarm) (77 = 100)	IV/85	170.5	167.8	163.9	1.6	4.0
Unit Nonlabor Costs (nonfarm) (77 = 100)	IV/85	158.0	161.4	158.4	−2.1	−0.3
Producer Price Indices (67 = 100)						
Crude Materials	Feb/86	290.5	301.3	318.9	−5.0	8.7
Intermediate Goods	Feb/86	313.5	319.5	319.5	−1.4	−1.6
Finished Goods	Feb/86	292.3	296.2	292.1	−1.6	0.1
FEDERAL SPENDING AND DEBT						
Federal Spending Index (67 = 100)	Jan/86	616.7	640.2	572.0	−3.7	7.8
Federal Government Debt Outstanding ($B) [a]	Sep/85	1,827.4	1,822.4	1,576.7	0.3	15.9
INTERNATIONAL TRADE						
Exports of Goods & Services ($B)	IV/85	368.7	363.2	389.5	1.5	−5.3
Imports of Goods & Services ($B)	IV/85	475.7	451.0	461.7	5.5	3.0
Balance on Goods & Services ($B)	IV/85	−106.9	−87.8	−72.2	21.8	48.1
WHAT'S AHEAD?						
Index of Leading Indicators (67 = 100) [a]	Jan/86	173.0	174.0	166.3	−0.6	4.0

NOTES: All data seasonally adjusted unless otherwise noted
[a] Not seasonally adjusted
[b] Percentage point difference
[c] January data is a new series that is not comparable to previous data

Federal Spending—The "Federal Spending Index," a U.S. Chamber devised measure of the monthly change in federal expenditures, increased by 7.8 percent in January compared to its year-ago level. Federal receipts for the first four months of the fiscal year increased by 7.3 percent, while expenditures for the same period rose by 6.8 percent. The federal deficit for the first four months of fiscal year 1986 was $82.8 billion compared to $78.8 billion during the same period in fiscal year 1985.

Personal Savings—In January, the personal savings rate was 4.0 percent of after-tax income, an improvement from the 3.4 percent rate reached in December. Personal savings were $114.1 billion in January, compared to $99.3 billion in December. For 1985 as a whole, savings as a percent of disposable income averaged 4.6 percent, the lowest rate since the Depression Era.

Retail Sales—Retail sales declined 0.1 percent in February following a revised 0.2 percent decline in January. Sales were up 4.6 percent from their year-ago level. Most of the February decline was due to lower gasoline prices. During February, department, furniture and home equipment stores continued to register strong gains. Durable goods sales were virtually unchanged compared to January, but were 7.6 percent above their February 1985 level. February nondurable goods showed no change from the January level, but were 2.9 percent above their year-ago level.

Trade Deficit—The 1985 merchandise trade deficit reached $148.5 billion. On a monthly basis, the January merchandise trade deficit reached a record $16.5 billion, which followed a new record set in December. About one-third of the increase in 1985's merchandise trade deficit was attributable to a lower level of exports, and two-thirds of the increase was due to a higher level of imports. On a goods and services basis, it averaged $107 billion in the fourth quarter, significantly above the $88 billion reported in the third quarter. In 1985, the trade deficit on a goods and services basis was $76.9 billion, an increase of $17.7 billion from 1984. In 1985, imports rose six percent, on a current dollar basis, from their year-ago level while exports fell 2.2 percent.

What's Ahead—The composite index of leading indicators, designed to predict future movements in aggregate economic activity, fell 0.6 percent in January, the first monthly decline since April 1985. The major contributors to the January decrease were contracts and orders for plant and equipment and change in credit demand. The decline in the indicators was not a decisive move since five of 11 indicators were up five were down and one was unchanged.

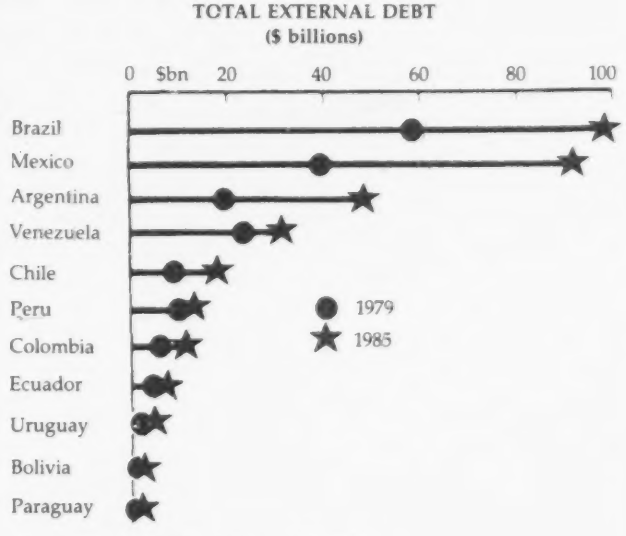
DEPARTMENT OF LABOR REPORTS EMPLOYMENT AND EARNINGS CHARACTERISTICS OF FAMILIES

The U.S. Department of Labor's Bureau of Labor Statistics reported that nearly 60 percent of mothers in families with children under 18 were employed during the fourth quarter of 1985. While the total number of families with school or preschool children rose by 460,000 over the year, the number with employed mothers increased by 765,000 to 18.2 million.

The total number of families with employed members grew by nearly 600,000 over the year to 50.8 million—81 percent of all families. The number of married-couple families with one employed member increased by 300,000 from a year earlier to 42.1 million. The number of families with unemployed members was virtually unchanged over the year at 5.9 million. Nearly 80 percent of the married-couple families with an unemployed member contained an employed member.

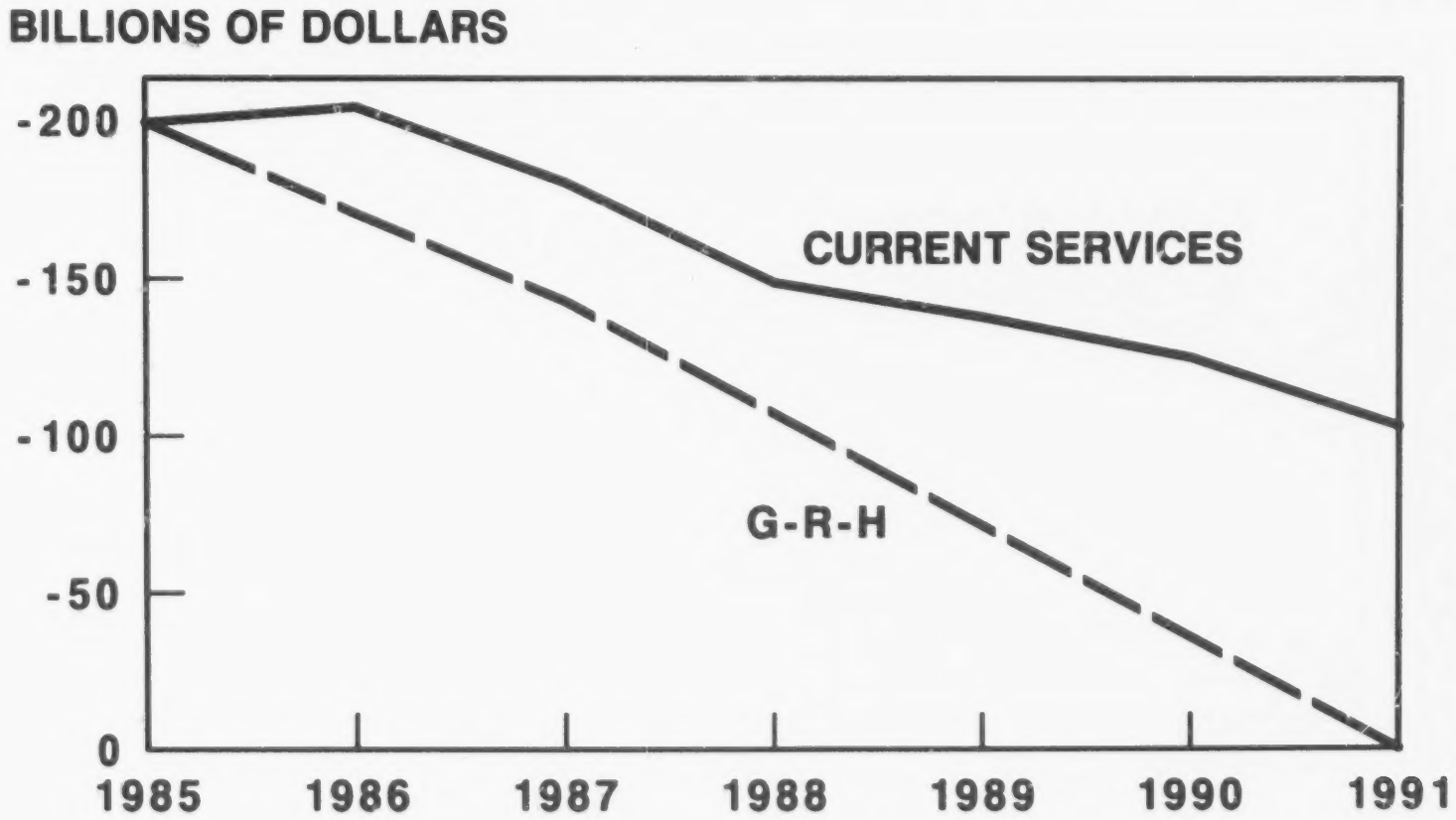
LATIN AMERICAN DEBT

Between 1979 and 1985, Latin American debt has doubled rising from $182 billion to $368 billion. Mexico and Brazil, the two largest debtors, owe $200 billion combined, more than half of the region's outstanding debt. Over the past six years, Mexico's debt has risen by 145 percent, from $40 billion to $98 billion. The amount of debt owed by Brazil increased half as much in percentage terms as that of Mexico, rising from $59 billion to $102 billion. Argentina falls next in line; its debt increased from $19 billion to $50 billion. Venezuela's debt increased from $23 billion to $30 billion.



Source: The Economist, February 15, 1985

CURRENT SERVICES DEFICIT VS. GRAMM-RUDMAN-HOLLINGS GOALS



GNP MINUS NET EXPORTS